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SIPDIS

STATE FOR EB A/S TONY WAYNE
STATE FOR WHA/CAN, EB/IFD, INR
STATE FOR WHA DAS WHITAKER
USDOC FOR 3000/ITA U/S RHONDA KEENUM
USDOC FOR 432/ITA/IAA/BASTIAN/RUDMAN/FOX
TREASURY FOR U/S (INTERNATIONAL AFFAIRS) TIMOTHY ADAMS
TREASURY FOR U/S (DOMESTIC FINANCE) RANDY QUARLES
DEPT ALSO PASS USTR FOR J. MELLE AND S. CHANDLER
DEPT PASS SEC - (INTERNATIONAL AFFAIRS) MARISA LAGO
DEPT PASS FEDERAL RESERVE BOARD
DEPT PASS TO IRS COMMISSIONER MARK EVERSON
WHITE HOUSE/NSC - KIM BRIER AND SUE CRONIN

SENSITIVE

E.O. 12958: N/A
TAGS: EINV EFIN PREL CA US
SUBJECT: The Canadian Financial Services Sector:
Playing Catch-Up on the Venture Capital Front

Ref: (A) Toronto 1633 (B) Toronto 1728

Sensitive But Unclassified - Protect accordingly.

¶1. (U) This message is one in a series reviewing the Canadian financial services sector from a cross-border, North American integration perspective. In September 2005 the Toronto Financial Services Alliance sponsored roundtables for ConGen Toronto with industry sector experts in venture capital, banking (septel), securities (septel), and insurance (septel).

¶2. (SBU) SUMMARY AND COMMENT: Canada's venture capital and private equity public policy association, the Canadian Venture Capital Association (CVCA), advised ConGen Toronto during a September 13 roundtable that it has mounted a campaign to increase the supply of risk capital available to Canadian entrepreneurs. One goal is to ensure that funds are properly channeled to support new enterprises that are commercializing technology coming from Canada's leading university and research institutions. CVCA is concerned that Canada's undersized venture capital industry and current regulatory framework stifle growth opportunities for Canada (and North America) and fail to take advantage of Canada's positive economic performance. CVCA cites, among other things, eight structural impediments to investment in Canadian venture capital that the federal government imposes on the industry via the Canada Income Tax Act. The CVCA expressed frustration that Canada's strength in publicly-funded university research is often commercialized in the U.S. due to a dearth of venture capital in Canada. To address these issues, the industry hopes to raise its profile in Canada and the U.S. to attract large institutional and pension fund investors to Canadian private equity funds and interest in several emerging homeland security-type technologies. The Security and Prosperity Partnership (SPP) Financial Services Sector Working Group may wish to factor these concerns into its work plan review. END SUMMARY AND COMMENT.

Boom and Bust - Context of Venture Capital in Canada
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¶3. (U) At a September 13 Canadian Venture Capital Association (CVCA) roundtable for ConGen Toronto, representatives of the private equity industry explained that the Canadian venture capital industry was a late starter compared with the U.S. Tracing its origins to the mid-1970s when the fledgling industry established the CVCA, the market only attained "take off" velocity during the 1990s with the technology bubble. Over 50 percent of Canada's venture capital industry is concentrated in Ontario. Major components of the industry focus on software and the life sciences in Toronto, telecom and Internet technology in Ottawa, and biotech and information technology in the "Golden Horseshoe technology triangle" around Kitchener, Waterloo, and Guelph. Quebec is the second largest market due in part to the province's dirigiste policies, which mandate that venture capital generated in Quebec must be invested locally. Western Canada's focus on resources, oil, and gas had not been conducive to the development of a venture capital industry, according to the CVCA; however, a small venture capital industry is developing in Vancouver, closely connected to the venture capital industry in Seattle.

¶4. (U) In the 1990's, growth was rapid, the CVCA told us, but when the high-tech bubble burst in late 2000 and early 2001 the descent was equally rapid. Capital was drained from the industry as venture capitalists fled the overwhelmingly tech-based venture industry. Currently, the 1,000 members of the CVCA manage some C$50 billion in assets. This is about 1/20 of the size of the U.S. industry and, in relation to population and GDP, half the size of the U.S. venture capital market.

Cross-Border Integration

¶5. (SBU) The CVCA has in recent years observed a trend towards cross-border integration of the venture capital industries in the U.S. and Canada. U.S. companies find certain aspects of the Canadian market attractive - competition is not as fierce, making returns significantly higher, and Canada's publicly funded universities are good incubators of intriguing technologies. U.S. companies that have recently come to Canada include KKR, the Carlisle Group, several Boston-based groups, and some funds from Washington and New York. Also, Canadian-based venture capitalists have recently succeeded in raising funds from U.S. firms. Most prominently, Celtic House, an Ottawa based group, sourced 50 percent of its funding from the U.S., which the industry here saw as a real breakthrough. Ventures West, a Vancouver-based group, and Jefferson Capital, based in Toronto, have in recent months recorded similar successes. The CVCA believes that the venture capital industry is in the process of becoming truly continental, with several smaller regional centers of gravity outside the main Toronto hub.

Digging out from the Tech Collapse

¶6. (SBU) CVCA described the big picture challenge as digging out from the tech collapse. This has been a slow and arduous task, according to the CVCA. In the best of times, Canadian venture capitalists have suffered in comparison to their U.S. counterparts from the relatively small pool of venture capital and the fact that Canadians tend to be more risk averse than Americans. The CVCA pointed to the following factors as slowing the recovery:

--Increased regulatory burden: according to the CVCA, the ultimate goal of any venture capitalist is to take fledgling private companies public and to cash in at the initial public offering (IPO). Following enactment in the U.S. of the Sarbanes-Oxley legislation and Canada's coordination with U.S. law (ref (A)), the costs to companies of complying with beefed-up disclosure provisions are dissuading small and micro cap companies from going public (i.e. issuing an IPO). The CVCA said the industry has, ironically, benefited to some degree in recent years from taking public companies private again;

--Loss of Canadian subsidies: The CVCA deplored the decision of the Ontario government to phase out a 30 percent tax credit previously given to Ontario residents who invest up to C$5,000 in designated pools of venture capital;

--Proximity and relative strength of the U.S. market: the CVCA confirmed that of Canada's best ideas migrate to the U.S. where venture funding is more readily available. As a result, Canada faces the "perverse" situation that its publicly funded university system acts as a great incubator for innovative ideas that are then developed commercially south of the border (ref (B)). A good example is the University of Waterloo, a leading Canadian math and high-tech engineering university, which supplies over 50 percent of its graduating classes to Microsoft Corp. (NOTE: Bill Gates has taken a personal interest in this university, often slipping in quietly to meet with Waterloo students, as he did on October 7. END NOTE)

Canadian Tax Act Impedes Venture Capital Industry
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¶7. (SBU) The CVCA reserved its harshest criticism for the federal government and has identified in a paper submitted to the federal Department of Finance eight structural barriers to investment in Canadian venture capital and private equity funds under the Canadian Income Tax Act. These problem areas include:

--Impediments to the use of Qualified Limited Partnerships (QLP), especially with regard to Canadian content restrictions, as a vehicle for venture capital and private funds.

--Passive investment as a limited foreign partner in a Canadian fund being subject to Canadian tax. Department of Finance letters of exclusion are not, the CVCA says, a reliable instrument to the general venture capital investor;

--Lack of tax treaty relief for U.S. LLC ("Limited Liability Company") partners under the Canada-U.S. Income Tax Convention, which often prevents a U.S. fund from investing in Canada. (NOTE: an LLC is a type of legal entity that combines the benefits of liability protection for the owners of the business with the potentially favorable tax benefits of flow through taxation. END NOTE);

--Cumbersome use of "parallel funds" to protect Canadian investors from Canadian withholding tax rather than a look-through mechanism that would require withholding of taxes only to the proportionate extent of the non-Canadian interest in the partnership;

--Delay in the issuance of Section 116 certificates following the completion of a corporate sale transaction, which has forced U.S. investors to delay the sale of their resulting shares in public markets. This has led to a growing perception that Canadian regulatory requirements do not accommodate market realities;

--The Non-resident tax return requirement even when no tax is payable and the transaction has been reported to the Canada Revenue Agency (CRA);

--Limits posed on "Associated Companies" eligibility for Scientific Research and Experimental Development (SR&ED) tax credits under current definitions that do not recognize genuinely independent associated companies; and

--Cross border merger provisions that deny a roll-over for shareholders of Canadian companies that receive shares of U.S. companies as a result of a merger transaction (NOTE: This single issue CVCA claims leads many experienced Canadian entrepreneurs to establish their new businesses as U.S. incorporated companies, even though the business is initially being formed in Canada. END NOTE).

¶8. (SBU) The CVCA emphasized that resolution of all eight impediments would not/not have any material fiscal impact on the Government of Canada. In each case, the identified structural barriers do not represent requests for lower tax rates or increases in other tax benefits. The CVCA argued that many of these impediments take the form of misguided nationalistic rules, such as "Canadian content" provisions, which scare away foreign investors. The CVCA also claimed that many of these eight structural impediments have been previously discussed with the federal Finance Ministry but, so far, have at best been only partially addressed in legislative amendments. The CVCA hoped the federal government would eventually remove these eight impediments to investment in Canadian venture capital (NOTE: The CVCA Paper "Summary of Tax Issues for Discussion with the Department of Finance" has been sent to WHA/CAN and Embassy Ottawa. END NOTE).

Planned Remedies

¶9. (SBU) The CVCA believes that its overarching goal must be to grow the pool of venture capital in Canada. To do so, the CVCA plans several measures, including:

--Campaigns to market itself better in Canada. Many small investors, the CVCA believes, are not aware or have a poor understanding of private equity funds. Roynat Capital, a venture company that hosted this roundtable discussion, is currently running full-page ads in the "Financial Post" (the business section of the National Post), featuring several venture capital success stories.

--The CVCA hopes to prod large pension funds of large institutional investors in the NAFTA area to take a new look at venture capital and invest more money in the industry. Among the targets is the Ontario Teacher's Pension Fund, Canada's largest pension fund. The CVCA mentioned the federal elimination of the 30% foreign property ceiling on Canadian pension funds in February 2005, as a recent positive development for the increasingly continental venture capital industry. In particular, pension funds have found it difficult to invest in venture capital pools, in which the domestic-to-foreign content ratio can fluctuate significantly.

--The CVCA believes that Canada is currently incubating several technologies with homeland security applications that would be of interest to both the Canadian and U.S. governments. They noted that U.S. Department of Defense contract awards to Canadian companies are almost twice as large as the defense contracts going to U.K. companies.

--The CVCA points to two favorable market trends that could lift the Canadian venture capital market. First, recent quarterly data - which are notoriously volatile - show a 50% jump in investment in Canadian venture capital pools, with 35% coming from outside of Canada (mostly from the U.S.). This investment from foreign sources was at its highest level in two years. Second, the federal government's September decision to all but freeze "income trust conversion" (a highly popular investment vehicle) is already increasing the flow of capital to the traditional IPO market.

Positive Government Initiatives

¶10. (SBU) In addition to these CVCA efforts, the industry hopes provincial and federal government initiatives will help the industry recover. For example, Ontario is supporting Centers of Excellence, which provide seed money to encourage commercialization of home-grown technologies in the areas of Energy, Communications & Information Technology, Public Infrastructure, Materials and Manufacturing, and Photonics Research. Also, the federal and provincial governments have partnered in establishing a Medical And Related Sciences (MARs) hub in Toronto, an attempt to turn medical research into commercially viable hospital applications. And on October 7 the Toronto Region Research Alliance (TRRA) was launched to implement a focused strategy to commercialize R&D in the Greater Toronto Area. Using San Diego as one model that has attracted a large number of venture capital firms, this new alliance has brought together the formidable talents of its founders Dr John Evans, president of MARs, former president of the University of Toronto and now Chair of the Board of Directors of the Canada Foundation for Innovation (CFI); Gordon Nixon President and CEO of RBC Financial Group, Canada's largest bank; David Pecaut, Managing Director of the Boston Consulting Group of Canada; and Ross McGregor, Chairman Emeritus of Ketchum Canada, Canada's leading fund development consultancy. This group hopes to bring the U.S.-based Battelle Institute to partner with the University of Toronto to create a world-class bio-tech commercialization facility and to establish a National Research Council presence in southern Ontario.

List of Attendees

¶11. (U) The venture capital industry was represented Dr. Robin Louis, President of CVCA and President of Ventures West Management; Richard Remillard, the CVCA's Executive Director; Bob Roy, Managing Director, Roynat Capital; Rick Nathan, Managing Director, Goodmans Venture Capital; Mark MacDonald, Buyout Specialist, OTPP Private Equity; and Arlene O'Neil, M&A Lawyer, Gardiner Roberts LLP. The Toronto Financial Services Alliance was represented by its President, Janet Ecker (former Ontario Minister Finance); and Susan Viegas, Economic Development, City of Toronto. The U.S. was represented by CG Jessica LeCroy; Consul for Economic/Political Affair Sherri Holliday; and Economic Specialist Colin White.

Background: the CVCA and the TFSA

¶12. (U) The CVCA - Canada's Venture Capital & Private Equity Association - was founded in 1974 to represent Canada's venture capital and private equity industry. Its over 1,000 members are firms and organizations that manage the majority of Canada's pools of capital designated to be committed to venture capital and private equity investments. The CVCA fosters professional development, networking, communication, research and education within the venture capital and private equity sector and represents the industry in tax and regulatory matters.

¶13. (U) The Toronto Financial Services Alliance (TFSA) is a joint public-private partnership created in 2002 by the City of Toronto's Economic Development Bureau and the Toronto-based financial services industry. The TFSA works closely with industry, affiliate services, and government to enhance and promote the competitiveness of Toronto as a premier North American financial center.